Shadow banking and European offshore financial centers: the blind spot in EU policy debates

Abstract

When Lehman Brothers collapsed, the wider public was exposed to the complex world of finance, where credit is intermediated in unconventional ways outside of the regular banking system. Such unconventional finance has become known as 'shadow banking'. This paper contributes to the debate on shadow banking by explaining the role of European offshore financial centers (OFCs), namely, the Netherlands, Luxembourg and Ireland, in facilitating large scale regulatory arbitrage and tax avoidance.

Current policy initiatives by the Financial Stability Board (FSB) and the EU have a blind spot where the role of OFCs in shadow banking is concerned. Furthermore, policy debates in the EU and OECD on tax avoidance ignore the role of tax arbitrage in shadow banking. This paper argues that an effective policy framework must address the European offshore dimension of shadow banking. This means that policies to address shadow banking should bring together both EU/FSB and EU/OECD policy processes to be effective. The discussion on tax evasion should be broadened to include the effect of tax havens on the spatial concentration of shadow banking activities.

Keywords: Shadow banking, tax avoidance, offshore centers, systemic risk, EU policy

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1. INTRODUCTION

The world of finance moved away from traditional banking in the decades leading up to the financial crisis of 2008. Since the 1990s in particular, innovative forms of intermediation facilitated an increasing leverage in developed economies (ECB 2012; IMF 2011a, 2011b; FSB 2011a, 2011b). 'Shadow banking' is the term coined for these complex forms of intermediating credit outside the traditional banking system. It is defined as 'financial intermediation by non-banks' and involves a broad range of actors, activities, products and markets that operate and interact across different jurisdictions. They include: repo markets, hedge funds, money market funds (MMF), securitisation vehicles and other special purpose entities (SPEs) (New York Fed 2010; FSB 2012b). An essential role is played by the largest investment banks, connecting the different shadow bank entities through their role as dealer, broker and underwriter. This makes these banks pivotal nodes in the shadow banking system. The overall size of shadow banking in terms of assets was an estimated US$71 trillion in 2012 – up from US$26 trillion in 2002 (FSB 2013).

The shadow banking system consists of a network of intermediaries interacting across different jurisdictions. Essential to this geography is the role of offshore financial centers (OFCs), such as the Netherlands, Luxembourg and Ireland, which act as conduit jurisdictions. These locations do not harbour the higher value added services of shadow banking found in first-tier financial centers such as New York and London, but instead provide a specialised service industry that facilitates pass-through entities processing large capital flows. Luxembourg, the Netherlands and Ireland accounted for 40% of all shadow banking transactions in the Eurozone in 2010 (European Commission 2012a). OFCs enable financial institutions to create levels of complexity that create the scope for regulatory arbitrage and allow for tax avoidance. At the heart of complex cross-border corporate structures is the large scale use of special purpose entities (SPE's), shell companies or brass-plate companies that offer domicile in OFCs. These pass-through entities add to systemic risk in the financial system and are the main vehicles for shifting profits and eroding the tax base (OECD 2013).

In this paper we demonstrate that the geography of shadow banking is relevant to understanding how it functions, and its capacity to circumvent rules and regulations. The corporate structure of banks and financial institutions, organised through myriad SPEs, enable the use of opaque funding channels. These funding channels build upon existing techniques, legal forms and institutions in OFCs. Non-financial transnational corporations (TNCs) have used OFCs for tax avoidance purposes for many decades (Palan et al 2010; Picciotto 1999; Roberts 1995). As the mobility of capital increased and globalization re-emerged in the 1980s, the specialised service providers, legal structures and institutional frameworks in OFCs matured, enabling them to process ever larger capital flows (Maurer 2008; Palan 2002, 2003; Rixen 2011; Wójcik 2013). Shadow banking entities appeared in OFCs in the 1990s and grew dramatically in the decade after the new millennium. These entities primarily use OFCs to open funding channels by emitting debt, often routing capital through different OFCs in the process.

It was recognised at the G20 meetings in Seoul in 2010 and Cannes in 2011, as well as by the European Commission in 2012, that shadow banking is a breeding ground for financial instability The G20 therefore asked the FSB to develop an effective framework to constrain these risks, and the FSB published an action plan in 2013. The European Commission set up a parallel process, publishing a green paper in 2012 and its own action plan in 2013. Both policy processes have not recognised the role of OFCs in shadow banking.

At the same time, and on a related but separate topic, there has been an attempt by the OECD and the EU to regain fiscal authority vis-à-vis growing tax avoidance by TNCs. The two bodies issued separate action plans, both of which failed to include shadow banking. This paper argues that an effective policy framework must address the European offshore dimension of shadow banking. This means that policies to address shadow banking should bring together both policy processes to be effective. The discussion on tax evasion should be broadened to include the effect of tax havens on the spatial concentration of shadow banking activities.

This paper starts with a brief description of shadow banking and the concerns voiced by the FSB, the EU and the US Federal reserve. These concerns focus on a set of systemic risks associated with the lack of a public back stop, the severe pro-cyclical nature (i.e. one that encourages booms and busts) of actors and the complex linkages with the regular banking system. Secondly, the paper discusses the nature of OFCs and how shadow banking is embedded in European centres. The Netherlands is highlighted, serving as illustration of how funding channels require OFCs. The third part of this paper gives a brief overview of current policies geared towards reducing the space for tax avoidance, and policies designed to bring shadow banking under control. This paper concludes by arguing that shadow banking should bring together both policy processes to be effective. The discussion on tax evasion should be broadened to include the effect of tax havens on the spatial concentration of shadow banking activities.

2. What is shadow banking?

Shadow banking is described by the FSB (2011a, 2012a) as a network of non-bank entities that intermediate credit in an unregulated market environment, outside conventional banking structures, that involves leverage and maturity transformation. Conventional banks are involved in maturity transformation by taking deposits from households and corporations and extending credit to households, corporations and the state. Long-term assets (such as mortgages) are financed with short-term liabilities (such as deposits) within the bank.

Shadow banking, essentially, does the same, transforming short-term liabilities into long-term assets. But the big difference is that shadow banking operates outside the regulated structure required for conventional banks, and involves a wide range of different actors in an uncoordinated and non-transparent set of activities. The short-term liabilities – the functional equivalents of deposits in the conventional banking system – are primarily money market funds (MMFs) and repo transactions (FSB 2011a, 2011b; New York Fed 2010; IMF 2011a, 2011b). The long-term assets are typically high-grade fixed income products (bonds), a variety of structured asset backed paper owned by structured investment vehicles, and other special purpose entities and conduit structures (ECB 2012; IMF 2011a). Shadow banking is essentially a network of intermediaries and as such it is a shadow banking *system* instead of a shadow bank.

Shadow banking proved to be highly unstable after the collapse of Lehman Brothers. Different markets froze, turned illiquid and collapsed, pointing to complex interconnections between different domains of modern financial markets. This instability can be traced to three separate clusters of problems. First, the market dynamics of shadow banking are prone to pro-cyclical behaviour, are non-transparent and inherently unstable. Second, the absence of a back stop by a public authority, a lender of last resort, creates the type of market problems that characterised the US financial system until the Federal Reserve was set up following the 'panic' of 1907. Thirdly, the shadow banking system is so intertwined with the conventional banking system that any instability it suffers cannot be isolated.

According to the FSB (2012a) the lack of transparency in separate segments of shadow banking – and in its interconnections – remains a prime obstacle for regulators in understanding and policing the market. This lack of transparency is found at both the macro and micro level. In particular, the cross-border and bilateral nature of transactions creates an opaque market environment, where existing statistics, methods and techniques provide insufficient oversight for national regulators (FSB 2012a).

Adding to problems caused by lack of transparency is the issue of pro-cyclicality, as shadow banking connects across separate markets and magnifies fluctuations. As particular long-term assets experience a boom – as residential mortgage-backed securities (RMBS) did up until 2007 – their use in the re-hypothecation process (repo markets and MMF) also increases. However, when the market for RMBS collapsed in 2008 so did their use as collateral in re-hypothecation. This shows that the change in the valuation of collateral is enhanced in good times and reduced in bad times and means that the market environment is pro-cyclical (FSB 2012b).

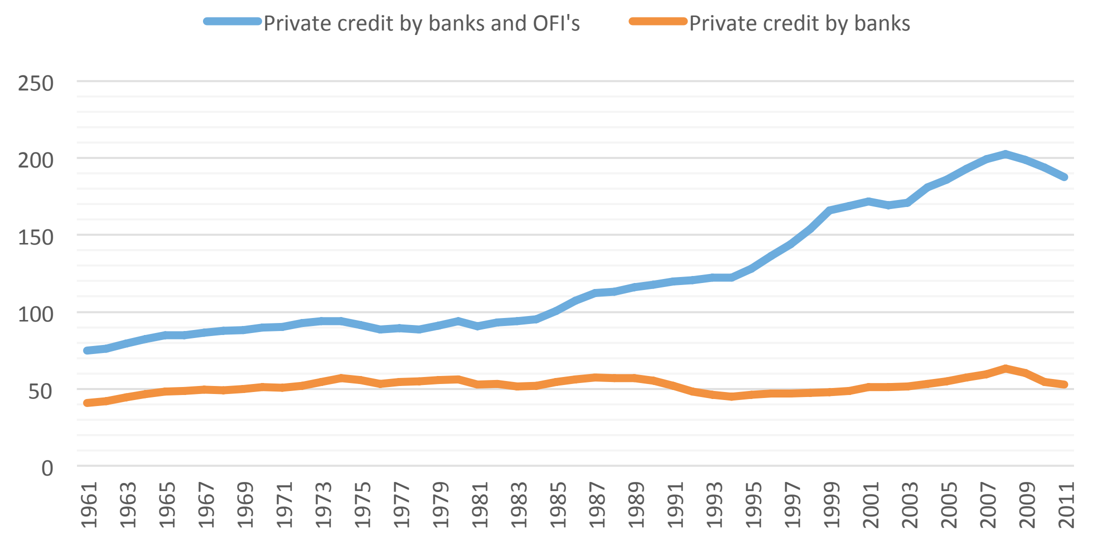
Another subject identified by regulators is the set of interconnections between shadow banking and regular banks. As we witnessed with the collapse of the subprime market in 2007, the interconnections of modern finance created different 'contagion channels', freezing markets previously understood to operate at a healthy distance from structured finance. Instead of seeing these two banking domains as separate, in 2012 Adair Turner, former chairman of the Financial Services Authority (FSA) argued that:

> *"We need to understand shadow banking not as something parallel to and separate from the core banking system, but deeply intertwined with it.(…) Shadow banking could, at least theoretically, exist as a standalone system parallel to but quite separate from banking. But in practice it didn't; rather the shadow banking system which actually developed involved complex interconnections between the banking system and shadow banks."* Adair Turner (2012).

The critical issue of the growing interconnectedness of conventional banking and shadow banking is the broader impact it has on overall debt levels worldwide. The role of conventional banking in extending debt declined in relation to the growing shadow banking system. In the EU, where a bank-based financial system is dominant, this effect has been less than in the US. Important exceptions are small, open economies with excessive (mortgage) debt levels such as the Netherlands and Ireland. Figure 1 shows private debt in the US owed to banks and 'other financial institutions' (OFIs), a proxy used by the FSB to quantify shadow banking.

Shadow banking is an intrinsic part of the global financial architecture that facilitated the growing private debt levels in developed economies from the 1980s onwards. While conventional banking is embedded in a range of regulatory structures, the shadow banking *system* is not. Attempts to re-regulate banking and financial markets since the great financial crisis may push the use of shadow banking further.

Figure 1. Private credit in the US as share of GDP



Next to issues of financial instability and its growing leverage in the regular banking system, shadow banking thrives in offshore financial centres (OFCs) and enables the conditions where taxes can be avoided (Palan et al 2010). Shadow banking consists of a variety of actors that often operate across different national jurisdictions. This geography helps different entities to create complex transnational interconnections. While regulation remains predominantly confined to the national scale, the network of shadow bank entities operates across borders on a global scale. This is the main political economy issue. How can we regain control over a transnational network of financial intermediaries that provide credit outside the regulatory reach of nationally organised jurisdictions? The example of Lehman Brothers provides a good illustration of how the geography of modern banking can best be described as an archipelago of entities scattered across OFCs.

The collapse of Lehman Brothers in 2008 showed how one of the largest and most successful Wall Street investment banks disintegrated into chaos, leaving behind a highly complex web of unwound inner company debt, derivative transactions, and joint financing programmes, connected by subsidiaries worldwide. The largest inner company debt, US$34 billion, was owed to an Amsterdam-based shell company, a typical Dutch shadow banking entity. Most Lehman Brothers subsidiaries, over 70, where located in the state of Delaware in the US, a well-documented tax haven. Other tax havens and OFCs that acted as stepping stones for Lehman Brothers were the Cayman Islands (with over 30 affiliates), Hong Kong, Singapore, Switzerland, The Dutch Antilles, the Netherlands, Luxembourg and Ireland.

Next to subsidiaries in the larger financial centers (London, New York and Frankfurt) that employed personnel and were regulated members of stock exchanges, we find a wide range of shell companies. These special purpose entities (SPEs), typically without employees and no rental contract or ownership of real estate, were scattered across many jurisdictions. The nature of these subsidiaries was always highly specialised – as opposed to the subsidiaries in the larger financial centres that offered a wide range of services and catered to a broad public, private and institutional clientele. Instead, these shell companies almost exclusively interacted with other Lehman Brothers entities and were booking or pass-through entities, issuing vehicles, or other types of SPE used for a variety of financial transactions. These empty shells acted as the machinery of Lehman Brothers outside the prime financial centres, through which regulations and taxes could be circumvented to achieve the optimum corporate structure across different jurisdictions.

For instance, the two vehicles located in Luxembourg specialised as repo counterparts and as issuance vehicles for securities hedged by derivatives by other Lehman Brothers entities, respectively. The Swiss subsidiary was the central vehicle used for booking the equity derivatives business, including OTC transactions and a broad range of specialised derivative products. The subsidiary incorporated in the Dutch ANetherlands Antilles was a fully owned subsidiary of Lehman Brothers' Asia holdings, and was primarily involved with issuing equity and debt certificates.

The Dutch subsidiary of Lehman Brothers – Lehman Brothers Treasury B.V. (LBTBV) – was a typical shell company with neither employees nor office. It required other Lehman Brothers entities to do the actual work, mainly the treasury function (holding and moving capital across accounts) and secretarial work. This shell company was central to the ability of Lehman Brothers to emit debt. Its Medium Term Note Program (EMTN) was responsible for 85% (US$100 billion) of all the planned long-term debt of Lehman Brothers in August 2007. The long-term funding, in turn, was a pivotal part of the strategy to increase leverage and income, with dramatic consequences. This broader context shows that the note programmes, in which the shell company located in Amsterdam acted as (co)issuer, was not a side show, but central to the overall Lehman Brothers strategy.

3. The offshore world meets shadow banking

In essence, shadow banking is a non-regulated transnational environment where the supply and demand for financial services and products of under-regulated entities is matched, priced, executed and institutionalised. It is the poster child for how a re-scaled financial system operates smoothly across national borders. The spatial configuration of shadow banking entities across the offshore world is critical to understand how it operates.

There is an extensive body of literature linking the offshore world with globalisation and financial innovation (Palan et al 2010; Picciotto 1999; Rixen 2008, 2011). This provides a firm foundation for understanding the historical process that gave rise to the shadow banking system. The London-based Eurodollar market, the mother of the offshore centres, plays a pivotal role in the IPE narrative on how capital mobility re-emerged (Helleiner 1994; Palan 1999; Strange 1996, 1998; Underhill 1999). The historical debris of the British Empire, and its offshore interconnections, provides the backdrop for many cases where tax avoidance has been exposed (Maurer 2008; Robinson 1994, 1995). In addition, the crucial role of onshore–offshore interactions in the development of global finance has been widely documented since the 1990s (Palan 1999, 2002, 2003; Picciotto 1999; Rixen 2011).

This paper builds on this body of literature that emphasises the offshore nature of financial globalisation. Offshore jurisdictions enable shadow banking entities to create levels of complexity that allow for tax avoidance and regulatory arbitrage. The large scale use of SPEs and shell companies that offer domicile in OFCs for financial and non-financial institutions lies at the heart of creating layers of complexity that only add to the systemic risk and the erosion of the tax base. This aspect of shadow banking adds an extra dimension to the complexity of shadow banking. This complexity slows down regulators in the different national jurisdictions and obstructs the quick and clear-cut separation of entities, responsibilities, assets and liabilities that is required in a crisis situation. Moreover it can lead to obscured leverage and counter-party risk.

Policymakers have voiced concern over the offshore architecture of financial markets. The growing transnational nature of corporations from the 1980s onwards was identified by the IMF as a "fiscal termite", i.e. a source for tax avoidance (IMF 2000). An IMF study, "in search of a definition for offshore financial centers", concluded (IMF 2007):

> "As indicated above, the current definitions of OFCs do not adequately capture the intrinsic feature of the OFC phenomenon, which is its raison d'être – the provision of financial services to nonresidents, namely, exports of financial services. Although one could argue that any given economy, to some extent, provides financial services, the peculiarity of OFCs is that they have specialised in the supply of financial services on a scale far exceeding the needs and the size of their economies. The following definition attempts to capture that feature so characteristic of OFCs: an OFC is a country or jurisdiction that provides financial services to nonresidents on a scale that is incommensurate with the size and the financing of its domestic economy."

Central to the way OFCs operate is the wide range of pass-through entities or SPEs domiciled in their jurisdiction. These entities, ranging from wholly owned subsidiaries to complex and opaque ownership structures mostly operate as 'brass plate' firm, or 'letter-box' companies, with no economic activity in the jurisdiction in which they are domiciled, but generate large capital flows.

> "In general terms, SPEs are entities with no or few employees, little or no physical presence in the host economy, whose assets and liabilities represent investments in or from other countries, and whose core business consists of group financing or holding activities." OECD 2013.

The Netherlands is an offshore financial centre, according to the size of the export of financial services in relation to the domestic economy. By different measures the Netherlands is a large financial entrepôt, with large inward and outward flows in relation to its domestic economy. The total size of transactions (inflow and outflow of FDI) of SPEs show the impact of the financial crisis. From a peak of €10.5 billion in 2008 they declined to €8 billion in 2011 (SOMO 2013). If we look at the largest jurisdictions in terms of the inward stock of FDI in 2011, described in Figure 2, we see that the Netherlands is the largest recipient. Luxembourg is the second largest. Other prominent OFCs in the group of 10 largest recipients are Hong Kong and Switzerland. The largest economies in terms of the outflow stock of FDI in 2011 were the US (US$2.8 trillion), followed by the Netherlands (US$2.3 trillion), the UK (US$ 2.2 trillion) and Luxembourg (US$1.8 trillion) (IMF data). The Netherlands and Luxembourg feature prominently in both the inward and outward stock of FDI, which emphasises their OFC function as conduit centre.

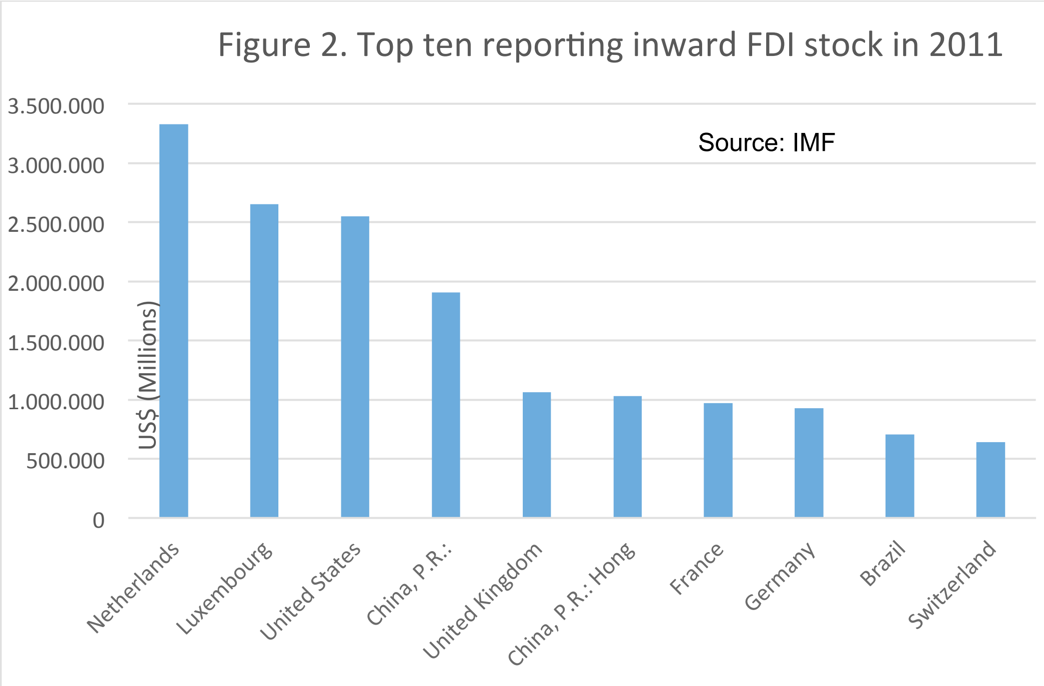


Table 1 shows the size of shadow banking activities, measured by the assets of the OFI sector and the banking sector in a number of FSB member states, as share of GDP. The US and the UK, with respectively 34% and 14% of worldwide OFI assets, are the leading shadow bank jurisdictions. Next are Japan and the Netherlands, both with 6% of FSB assets. Japan is the third largest economy and Tokyo remains one of the central global financial centres. The Netherlands on the other hand is not a major economy but an OFC, which captures large global OFI flows through its SPEs, discussed above. Ireland and Luxembourg are not part of the FSB and are therefore absent from FSB studies. The size of the OFI sector in the EU is disproportionately concentrated in the UK (29%), Luxembourg (17%), the Netherlands (15%) and Ireland (8%). The largest economies of the Eurozone, Germany (7%), France (7%), and Italy (4%) are small players in the European OFI sector (European Commission 2012a).

Table 1. Assets as percentage of GDP (2012)

	OFI sector	Banking sector
Netherlands	564,7	370,4
UK	354,4	800,5
Switzerland	233,5	353,4
Eurozone	183,7	302,5
Hong Kong	171,4	728,3
US	165,9	95,6
South Korea	108,3	195,5
France	96,2	366,1
Canada	92,1	217,6

4. Regulating shadow banking

The previous section showed that shadow banking is highly concentrated in OFCs. However, present policy debates ignore this financial geography. The EU and OECD's approach to tax avoidance, and the EU and FSB's approach to shadow banking share one thing: a blind spot in relation to the role of OFCs in shadow banking. The problem of tax avoidance, to which SPEs in OFCs are central, does not include shadow banking. The action plans directed towards shadow banking do not include the role of OFCs.

The current OECD-initiated debate on base erosion and profit shifting (BEPS) is the most advanced action plan so far to change fiscal regimes across jurisdictions and harmonise standards in order to scale back the tax avoidance structures and loopholes enabling TNCs to lower their tax base. The BEPS process is still in its very early stages and its successful implementation requires the overcoming of many obstacles. In the end, the devil will be in the detail. A critical issue is how the general principles formulated in a 15-point action plan will be operationalised into concrete policy proposals (OECD 2013b). Still, this initiative is an unprecedented shift in the OECD's attitude towards tax avoidance and has acted as a catalyst, pushing the EU commission and parliament to transform the existing policy framework as well. The BEPS process runs in tandem with G20 calls on transforming the international financial architecture and fiscal regime.

The parallel process in the field of shadow banking is being pushed forward by the FSB, assigned by the G20. Here too the EU Commission has set up a parallel EU policy framework. Both the FSB and the EU have an action plan to re-regulate different aspects of shadow banking. Separate entities are being dealt with in specifically targeted directives and regulations. The policy recommendations of the FSB focus on five areas (FSB 2013b). The first and the fifth are most relevant for regulating the role of SPE's.

The first is to "mitigate the spill-over effect between the regular banking system and the shadow banking system" (FSB 2013b, p1). This is to be addressed by the Basel Committee on Banking Supervision (BCBS), to ensure that a prudential regime is constructed to govern interactions between banks and shadow banking entities. The fifth set of policy recommendations aims to "assess and mitigate systemic risks posed by other shadow banking entities and activities".

> *"Because shadow banking entities take a variety of forms and are evolving over time, the FSB has developed the high-level policy framework to detect and address sources of financial stability risks from shadow banking. This framework is designed to allow authorities to capture innovations that occur outside the bounds of bank regulation and to adopt regimes for taking actions on non-banks that pose a threat to financial stability from shadow banking."* (FSB 2013b, p 3)

What is missing in both the FSB and the EU action plans on shadow banking is a focus on SPEs and OFCs. While the BEPS process leaves out shadow banking, shadow banking initiatives leave out the overlap with the BEPS process. The window of opportunity to act on lessons learned from the collapse of Lehman Brothers may be closing. Shadow banking has only grown since the crisis, and has fared well in the context of easy monetary policies of central banks in advanced economies. Also within shadow banking we may expect to a shift from entities that are being re-regulated, such as money market funds, to non-regulated SPEs-based intermediation.

Conclusion

Shadow banking is firmly rooted in OFCs. These financial centres act as conduit centres that facilitate immense capital flows generated by shadow banking entities. The underlying mechanism at work is the competition of financial centres in an age of hyper-mobile and fungible capital. We argue that these jurisdictions matter when trying to put in place effective forms of control and regulation for global finance. As long as OFCs offer a safe place for SPEs, financial institutions and banks can continue to operate in a lightly regulated environment. This dangerous scenario needs to be addressed.

The current focus of the OECD, FSB and EU has left a policy gap. This gap needs to be bridged by both policy processes. The OECD, the FSB, the G20 and the EU should take note of the concentration of OFI flows in a small group of countries. This uneven geography of OFI activities shows that differences in regulation and tax regimes lie at the heart of how shadow banking is spatially organised across jurisdictions. This should have consequences for analysis and policy measures. First, the degree to which the behaviour of banks and TNCs is shaped by fiscal considerations should be part and parcel of the approach towards shadow banking. Secondly the discussion on tax evasion should be broadened to include the effect of tax havens on the concentration of shadow banking.

As long as OFCs are allowed to offer safe haven for financial institutions aiming to circumvent regulation and taxes, we will be confronted with a dual-market environment. On the one hand we have the conventional market, which includes a clear regulatory framework, at which the vast majority of new banking regulation initiatives are aimed. On the other hand we have the financial activities that take place in the offshore world. This duality may lead to an ever-larger shadow banking system. Tackling the issue of OFCs is not only important to push back tax avoidance, it is essential if we are to be able to properly regulate and supervise global finance in the post-financial crisis world.

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